Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB:6:OKL:GL-150857-02
WFCastor

date: NOV 27 2002

to: Manager, Insolvency Group 5 Stop 5024-OKC

from: Associate Area Counsel (SB/SE) Stop 2000-OKC

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subject: **Advisory Opinion: Erroneous Refund After Chapter 13 Discharge**

Taxpayer: [redacted]
SSN:

This memorandum responds to your memorandum of September 18, 2002, requesting our views as to the advisability of an erroneous refund suit with respect to the above-named taxpayer.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact us for our views.

ISSUES

I. Whether the taxpayer's discharge may be revoked in Bankruptcy Court.

II. Whether the Service should institute an erroneous refund suit under I.R.C. § 7405, commence deficiency procedures under I.R.C. § 6211 et seq. to reassess the tax, or commence collection action on the theory the assessed tax was revived by the erroneous refund.

III. Whether an erroneous refund suit may be enjoined under the discharge injunction of 11 U.S.C. § 524.

CONCLUSION

An erroneous refund suit may be instituted in federal district court within 2 years of the making of the refund, under I.R.C. §§ 7405 and 6532. While the Service may not seek to have the bankruptcy discharge revoked as a result of the erroneous refund, the Service is not foreclosed by the discharge injunction from instituting an erroneous refund suit. (b)(7)e [redacted]. Any recommendation to bring suit should be sent to our office, pursuant to IRM 5.17.4.14.3 and 25.3.

FACTS

On [redacted], [redacted] ("the taxpayer") filed a Chapter 13 bankruptcy petition. On [redacted], the taxpayer's plan, which provided for full payment of the Service's priority claims for [redacted], [redacted] and [redacted] income tax liabilities, was confirmed. On or about [redacted], the Service received a payment of $[redacted], fully satisfying the taxpayer's [redacted], [redacted] and [redacted] income tax liabilities of $[redacted], $[redacted] and $[redacted], respectively.

The taxpayer's income tax accounts for [redacted], [redacted] and [redacted], however, reflected the release of a litigation freeze code posted on [redacted], prior to the [redacted] payment. The accounts also reflected a miscellaneous transaction code, also posted on [redacted], indicating that the taxpayer received a full discharge in bankruptcy, and a companion transaction code which cleared, or abated, the assessed tax on the accounts.

As a result of the full abatement of tax in [redacted], the [redacted] payment of $[redacted] was refunded, with interest, on [redacted], which amount totaled $[redacted]. The $[redacted] refund is attributable to the [redacted], [redacted] and [redacted] accounts in the amounts of $[redacted], $[redacted] and $[redacted], respectively. On [redacted], the Chapter 13 trustee filed a final report indicating that the plan had been completed, and on [redacted], the taxpayer received a discharge.

DISCUSSION

I. Whether the taxpayer's discharge may be revoked in the Bankruptcy Court.

Under 11 U.S.C. ("Code") § 1328(a), as soon as practicable after completion of a debtor of all payments under a Chapter 13 plan, the Bankruptcy Court is required to grant the debtor a discharge of all pre-petition debts provided for by the Chapter 13 plan, i.e., a "super-discharge."[1] The taxpayer in this case received such a discharge on [redacted], thereby discharging his [redacted], [redacted] and [redacted] income tax liabilities.

Under Code § 1328(e), the Bankruptcy Court may revoke the discharge granted under Code § 1328(a) only if the discharge was obtained by a debtor through fraud, and the requesting party did not know of such fraud until after the discharge was granted. A Chapter 13 discharge may not be set aside on general equitable principles. In re Daniels, 163 B.R. 893 (S.D. Ga. 1994). In this case, neither the taxpayer's discharge nor the Service's issuance of the erroneous refund resulted from fraud. Thus, the discharge may not be revoked.

II. Whether the Service should institute an erroneous refund suit under I.R.C. § 7405, commence deficiency procedures under I.R.C. § 6211 et seq. to reassess the tax, or commence collection action on the theory the assessed tax was revived by the erroneous refund.

The question of whether the erroneous refund issued the taxpayer was a rebate refund as defined by I.R.C. § 6211(b), or was a non-rebate refund, is relevant to determining the appropriate means by which the refund may be collected. A rebate refund occurs where the Service abates or reduces part of the tax imposed on a taxpayer on the basis that the correct tax is less than the tax previously imposed, and the Service makes a refund because of the elimination of a liability against which to apply the refunded amount, i.e., the refund is issued based on a determination by the Service as to the taxpayer's liability.

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[1] Code § 1328(a) does contain a few exceptions, e.g., claims under Code § 1325(a)(5), and debts excepted from discharge under Code §§ 523(a)(5), (a)(8) and (a)(9). Tax debts under Code §§ 523(a)(1), including priority debts under Code § 507(a)(8), are discharged, assuming the debts have been "provided for" by the plan. In this case, the tax liabilities were provided for, and in fact paid through, the taxpayer's Chapter 13 Plan.

A rebate refund is generated when the taxpayer either computes his liability on the return as less than the amount he has already paid, or files an amended return adjusting the liability reported on his return downward. A rebate refund is erroneous when the Service, after making the refund, determines on the merits that the amount of tax reported by the taxpayer is understated. Because the Service is redetermining the amount of tax in a rebate situation, the deficiency procedures of I.R.C. § 6211 et seq. must be followed where applicable.

A non-rebate refund is any refund that is not a rebate refund. A non-rebate refund results from a mechanical, clerical, or mathematical error, in contrast to a rebate situation, where the Service determines that the refund is erroneous because the taxpayer understated his or her liability. Examples of non-rebate refunds include applying a credit to a wrong module, typographical errors, an overstatement of income tax prepayment credits, cashing a duplicate check for a correct refund where the original check has also been cashed, and misrepresentation of a material fact or fraud by a person who is not the taxpayer to obtain a refund on behalf of the taxpayer, i.e., the error in issuing the refund does not relate to the determination of tax, but is clerical in nature.

In this case, as indicated above, the Service abated the tax based upon the discharge and released a litigation freeze code prior to the bankruptcy payment. Such error represents a non-rebate refund. See, e.g., The Mildred Cotler Trust v. United States, 98-1 U.S.T.C. ¶ 50,309 (E.D. N.Y. 1998)(held that an erroneous refund issued as a result of the release of a hold code upon bankruptcy discharge and prior to assessment was a non-rebate refund).

Because the erroneous refund in this case is a non-rebate refund, rather than a rebate refund as defined by I.R.C. § 6211(b), no deficiency exists under I.R.C. § 6211. Thus, the Service may not properly resort to the Internal Revenue Code's deficiency procedures at I.R.C. § 6211 et seq. See Davenport v. United States, 91-2 U.S.T.C. ¶ 50,531 (W.D. Ky. 1991). (b)(5)(AC)

[redacted]

Formerly, the Service had taken the position that, in the case of non-rebate refunds, the Service could rely on its assessment lien and levy powers under I.R.C. §§ 6321 and 6331, et seq., to

collect an erroneous refund, as long as the limitations period under I.R.C. § 6502 had not expired. In support of this position, the Service relied upon legislative history to I.R.C. § 7405, which indicated that "if the limitation period on the making of assessments has not expired, the erroneous refund may be recovered by assessment in the ordinary manner," S. Rep. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 (Pt. 2) C.B. 409, 438, and upon various case law. See, e.g., United States v. C & R Investments, Inc., 69-1, U.S.T.C. ¶ (10th Cir. 1968), aff'd after remand, 71-2 U.S.T.C. ¶ 9,515 (reversal of erroneous credit left liability unsatisfied and thus could be collected under assessment procedures).

The Service's position was based on the rationale that a non-rebate erroneous refund in an amount equal to but not exceeding the amount of tax reported on a return and paid reinstates the tax liability and the assessment. Because the tax continues to be owed, it can be collected through the Service's administrative, or summary, collection procedures. After mailing of notice and demand as required by I.R.C. § 6303, a lien is created under I.R.C. § 6321 on all of the taxpayer's property or rights to property such that the Service's levy powers under I.R.C. § 6331 are triggered. The theory is based on the equitable proposition that taxpayers who received back a portion of their tax liabilities for a year have not fully paid the liabilities, and they are unjustly enriched to the extent they are allowed full credit for their original payments and are allowed to keep the monies erroneously refunded them.

However, the only case before 1998[2] which supported the Service's former position that an erroneous refund activated a once-paid assessment was Groetzinger v. Commissioner, 69 T.C. 309 (1977), in which the Tax Court held that a non-rebate erroneous refund did not create a deficiency but, instead, revived the original assessment because the liability was unpaid. Many cases have held contrary to Groetzinger, finding that the erroneous refund to the debtors did not revive their discharged tax liabilities, but created a new non-tax debt to the United States.

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[2] The Mildred Cotler Trust v. United States, 98-1 U.S.T.C. ¶ 50,309 (E.D. N.Y. 1998), mentioned above, held that the Service could properly use its administrative procedures to collect an assessment which was revived as a result of a non-rebate erroneous refund. However, while the case has similar facts, i.e., the erroneous refund was issued as a result of the release of a hold code upon bankruptcy discharge and prior to assessment, the district court's opinion was extremely fact driven, and emphasized the existence of a stipulated decision and, thus, of a undisputed tax liability.

See Marshall, 158 F. Supp. 793 (E.D. Tex. 1958), which stated:

> When the plaintiffs [the taxpayers] paid their respective income taxes ... such taxes as to the plaintiffs were extinguished and the subsequent refund to the plaintiffs of a portion or all of the money paid by them as ... income taxes did not restore the taxes ... Defendant's [the United States] suits against the plaintiffs ... were no more than ... demands for the repayment to the Government of moneys which had been illegally and by mistake paid by an officer of the United States to the plaintiffs herein, and, therefore the sums found to be due the United States in those cases as set out in the judgments in those cases were not debts of the plaintiffs due the United States as a tax levied by the United States.

Since Groetzinger, as indicated in In re Chene, 82 A.F.T.R.2d 98-6754 (M.D. Fla. 1998), citing Bilzerian v. United States, 86 F.3d 1067, 1069 (11th Cir. 1996), Clark v. United States, 63 F.3d 83, 87-88 (1st Cir. 1995), O'Bryant v. United States, 49 F.3d 340, 347 (7th Cir. 1995), and United States v. Wilkes, 946 F.2d 1143 (5th Cir. 1991), a majority of the circuit courts have held that tax assessments are extinguished upon payment, and may not be revived by an erroneous refund.

The Court in In re Chene, citing O'Bryant, 49 F.3d at 347, stated the rationale for this holding:

> [E]rroneous refunds and tax liabilities are simply not of the same ilk. When a taxpayer mails the IRS a check in the full amount of his assessed liability, and the IRS cashes it, the taxpayer's liability is satisfied, and unless a new assessment is made later on, any erroneous unsolicited refund that the IRS happens to send the taxpayer must be handled on its own terms, not under the rubric of the assessed liability. That is, the IRS must use the statutory procedures Congress has provided for it to collect refunds.

Because a non-rebate refund cannot be collected by implementation of the Service's deficiency procedures, nor by resorting to collection of the assessment on the premise the assessment was revived by the refund, the statutory procedures Congress has provided to collect non-rebate erroneous refunds are confined to an erroneous refund suit, pursuant to I.R.C. § 7405.

Please note that the situation in which tax assessments extinguished by payment should be distinguished from the situation in which tax assessments are abated by the Service pursuant to I.R.C. § 6404(c). Under that section, the Service is authorized to abate the unpaid portion of an assessment of any tax or any liability in respect thereof if it is determined under uniform rules prescribed by the Service that the administration and collections costs involved would not warrant the collection of the amount due. Such an abatement includes abatements by Insolvency after a bankruptcy discharge. See IRM 5.9.

An abatement under I.R.C. § 6404(c) does not entail a determination of whether the assessment reflects the taxpayer's true liability, but only represents the Service's judgment that collection is not cost-effective. The underlying liability in such case is not extinguished. See Crompton-Richmond v. United States, 311 F. Supp. 1184, 1186 (S.D. N.Y. 197)(Service can revive assessment abated under section 6404(c) because abatement of uncollectible tax does not cancel tax). Thus, because an abatement under I.R.C. § 6404(c) does not extinguish the underlying liability, an adjustment may be made to the account to reverse the abatement where, for instance, the adjustment is made prior to a final distribution by a Chapter 7 trustee.

In this case, the accounts were abated based upon the bankruptcy discharge. However, we feel that this case is distinguishable from the case where an account is abated under I.R.C. § 6404(c) and reversed prior to a distribution or payment, as the taxpayer in this case fully satisfied the liabilities prior to the reversal of the abatement. (b)(5)(AC) [redacted].

Under I.R.C. § 7405(a), any portion of income tax which is erroneously refunded may be recovered by civil action brought by the United States. Such a suit must be filed within two years after the erroneous refund, except where it appears that any part of the refund was induced by fraud or misrepresentations of a material fact, in which case the period is five years. I.R.C. § 6532. Any erroneous refund suit must be filed by [redacted], which is two years from the date of the refund checks.

The Internal Revenue Manual, at IRM 5.1.8.7.1, 5.17.4.14.3 and 25.3, contains discussions concerning the recommendation of an erroneous refund suit. (b)(7)e [redacted].

III. Whether an erroneous refund suit may be enjoined under the discharge injunction of Code § 524.

Under Code § 524(a), a discharge in a bankruptcy case has the effect of: (1) voiding any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under, inter alia, Code § 1328; and (2) operating as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor.

As indicated above, the remittance of the erroneous refund did not serve in reviving the debtors' discharged liability, but constituted a new and separate post-petition claim. In that regard, any resulting judgment would not be void under Code § 542(a), as such judgment would not be a determination or collection of the personal liability of the taxpayer with respect to any debt discharged under Code § 1328.

Moreover, although debtors have been protected against personal judgments regardless of when the judgments were entered, the courts have found such judgments null and void where the judgment creditor could have raised the action in bankruptcy court, but chose to subsequently bring an action in state court. See In re Levy, 87 B.R. 107 (Bankr. N.D. Cal. 1988). The purpose of Code § 542(a)(1) was to end the harassment of discharged debtors by prohibiting creditors from using state courts, and presumably, federal district courts, to attempt to collect discharged debts. Houghton v. Foremost Financial Services Corp., 724 F.2d 112 (10th Cir. 1983).

In this case, however, such judgment would not be void for failure of the Service to urge the matter in bankruptcy, as the judgment would relate to a cause of action which arose subsequent to the taxpayer's completion of payments as a result of the taxpayer's bankruptcy discharge in [redacted].

If you have any questions, please call Will Castor of our office at extension [redacted]. We are closing our file.

/S/ MICHAEL J. O'BRIEN

MICHAEL J. O'BRIEN
Associate Area Counsel (SB/SE)

cc: Area Counsel (SB/SE), Area 6
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